VZCZCXRO4604
OO RUEHDBU RUEHFL RUEHKW RUEHLA RUEHROV RUEHSR
DE RUEHRA #0497/01 1870835
ZNY CCCCC ZZH
O 060835Z JUL 07
FM AMEMBASSY RIGA
TO RUEHC/SECSTATE WASHDC IMMEDIATE 4150
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY

C O N F I D E N T I A L SECTION 01 OF 03 RIGA 000497

SIPDIS

SIPDIS

E.O. 12958: DECL: 07/05/2017
TAGS: ECON EFIN EINV PGOV LG
SUBJECT: LATVIA: HARD SELL FOR GOVERNMENT ANTI-INFLATION
PLAN, BUT DEVALUATION STILL UNLIKELY

REF: RIGA 166

Classified By: Ambassador Catherine Todd Bailey, for Reasons 1.4 (b) an
d (d)

¶1. (C) Summary. The government's anti-inflation plan has been received skeptically, as evidenced by the downgrading of Latvia's credit rating by Standard and Poor's in May. A research group's June recommendation that Latvia devalue its currency to help fight inflation and restore export competitiveness gained press attention, but banking industry experts and the government continue to discount the possibility of a change in the lat-euro peg. Banking and government sources cite the Bank of Latvia's coverage of the lat with foreign reserves and the government's low debt to GDP level as sources of stability. Political calculations also do not make a devaluation as desirable as some academics depict. Though large inflationary forces are still working through the economy, an apparent slowdown in consumer lending and real estate prices may reduce some of that pressure, if government ministries can resist spending on favorite projects. End Summary.

Government Takes Action

¶2. (C) The GOL's official response to recent inflation concerns began on March 6, when the Latvian Cabinet of Ministers endorsed an anti-inflation plan developed by a Finance Ministry-led task force. The plan included 34 measures, with the most notable items aimed at decreasing internal demand by moving the government's budget from deficit to surplus by 2009 and limiting big-ticket government construction projects, altering tax policy to curb real estate speculation and purchases of luxury cars, and the imposition of new regulations to control the growth of consumer lending. The Bank of Latvia endorsed the plan, but in meetings with the embassy, the Governor of the Bank admitted that the plan was the bare minimum the government could credibly propose. The plan was received skeptically by banks and credit rating agencies, but the Bank of Latvia and the ministries of Economics and Finance have been consistently upbeat with predictions that the plan's positive effects would be seen by this summer.

Skeptical Reaction

¶3. (U) The rating agencies Standard and Poor's and Fitch both noted their concerns with the pace of the government's response to inflation over the last year and several press articles questioned the government's commitment to reigning in spending. The current budget valid through the end of the year envisions extra spending for such items as NATO program implementation and increasing wages for medical workers, pensioners, judges and other officials. Doubts about the

government's ability to control spending were put in the spotlight in early May when the Finance Minister floated a proposal to increase the Value-Added Tax (VAT) from 18% to 20%, explaining that the "national budget cannot meet the ministries' increasing demands anymore". This proposal was quickly scuttled, aided by the Bank of Latvia's public assessment that the VAT increase would raise average annual inflation by 1 to 1.7 percentage points.

¶4. (U) The Saeima (Parliament) passed a package of legislation to implement the anti-inflation plan on May 17, however that was overshadowed the same day by an announcement by Standard & Poor's (S&P) that they were lowering Latvia's credit rating from A- to BBB . S&P attributed the downgrading to an increased risk of a hard landing for the Latvian economy and persistent external imbalances (Latvia's current account deficit reached 25.7% of GDP in the first quarter of 2007).

Optimism Pounded by BICEPS

¶5. (U) The government decried S&P's move as too hasty, and in early June was able to point to a marginal drop in annualized monthly inflation when the economic data for May was released (8.2%, down from 8.9% in April), the first decrease in inflation growth in six months. Once again, though, the government's optimism was overshadowed by a gloomy forecast. The Baltic International Center for Economic Policy Studies (BICEPS) issued a study on June 7 which stated that recent surges in producer prices and wages (with wage increases as high as 23% over last year in some sectors, and a roughly 30% hike in natural gas prices taking effect on May 1) had already put more inflation into the pipeline, and that it is

possible that the Latvian economy has "shifted from a position of simple overheating to something more serious in structural terms". The economic press quickly picked up on the study's conclusion that the lat (Latvia's currency) is pegged to the euro at an unfavorable rate which is harming Latvian exports and undermining the effectiveness of the anti-inflation plan's fiscal measures. The report concluded by mentioning the dreaded subject of currency devaluation (see reftel), stating that "Latvia may eventually find itself in a situation where the pain of a long and costly period of deflation may be weighed against the cost of altering the peg to strengthen competitiveness - and where the latter may be the rational and less painful choice".

Experts Still Say Devaluation is Remote Possibility
--- -------

¶6. (C) Despite the renewed public discussion of devaluation that the BICEPS report generated, government and banking sector economists still view devaluation as a very remote possibility. Pol-Econ Chief spoke with economic specialists from both GE Money Latvia and HansaBanka, and both said that they did not see devaluation as a likely option for the government. They cited, as often do the Ministry of Finance, Prime Minister's Office and the Bank of Latvia, that the central bank has enough foreign reserves to fully cover the Latvian currency. The minor run on the lat that occurred earlier this year, it is also pointed out, was not from banks or institutional speculators, but was initiated by a text-messaging campaign that the government believes was linked to smaller currency exchange businesses trying to capitalize on devaluation rumors. HansaBanka's economist, Peteris Strautins, also pointed to the political cost of devaluing the currency. While average consumer debt is at a level comparable with other EU countries, he noted that consumer debt levels have grown rapidly (60% over last year) from a low base, and there are many Latvian households dangerously overextended on credit. Given that 70% of lending in Latvia is done in euros, a devaluation of the lat would have disastrous consequences for those consumers, and

they could vent their economic frustrations on the ruling coalition.

¶7. (C) Strautins added that a key stabilizing factor for the government is the very low level of state debt (10% of GDP), giving the government broad leeway to take on more debt to address any politically-sensitive issues or needs during a prolonged deflationary period. He said that he thought many inflationary factors had in fact already turned the corner, citing that consumer lending has started to drop substantially, construction is slowing because of labor shortages, and the real estate market is seeing falling prices in some areas. (The Bank of Latvia's governor confirmed these trends in a June 7 interview.) Strautins said that this would help the government's anti-inflation plan with reduced GDP growth. His main concern, Strautins noted, is that the plan had come in too late and the effect could be too much of a brake on the economy if it is indeed slowing. He stated that he could envision GDP growth dropping all the way to 4% next year (from 12% in 2006) in a worst case scenario.

¶8. (C) Comment. At this time, it is impossible to say if the government's anti-inflation plan can make a substantial dent in inflation over the upcoming year, though there are encouraging signs that lending and real estate pressures have peaked. The BICEPS report cited a 15-month lag between producer price increases and the resultant consumer price inflation, so we will not immediately know if reductions from any current cooling of the economy can offset the inflation already in the pipeline. Energy prices will take another hit in 2008, with a projected 15-18% hike in electricity rates, and inflation expectations will be hard to overcome as workers ask for further wage increases to make up lost buying power. The government and Bank of Latvia continue to do their jobs in maintaining optimism, and the government projects 2007 inflation to end up in the 7-8% range. The Bank of Latvia does appear committed to maintaining the current lat-euro peg, and has the foreign reserves to do it. From the political side, it is virtually impossible to see the government opting for the BICPEPS report's recommendation of a quick fix through devaluation of the lat under current conditions. The thousands of consumers suddenly having to earn more lats to pay off their euro-denominated debts would likely blame the government directly for mismanagement of the economy, while any blame for hardships caused by the current anti-inflation measures could potentially be deflected towards outside entities such as the credit rating agencies, Nordic banks, or even the EU. While the government's efforts address the current inflation dynamics, they do not address

the coming the tidal wave of $4.5 billion USD spread over seven years of EU Structural Funds which will soon be hitting the Latvian economy. End comment.
BAILEY